ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author:	Arambula	Analyst:	Darrine Distefano	Bill Number:	AB 2595
Related Bills:	See Legislative History	Telephone:	845-4142	Introduced Date:	February 24, 2006
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Depreciation Deduction/Qualified Manufacturing Equipment/Taxpayer May Elect To Take Deduction For Entire Cost In 3 Years

SUMMARY

This bill would provide a tax deduction for expenses paid for manufacturing equipment.

This bill would also make changes to sales tax provisions that would not impact the department and will not be addressed in this analysis.

PURPOSE OF THE BILL

According to the author's office, the purpose of this bill is to provide tax incentives that would establish, attract, and retain small manufacturing facilities in the state.

EFFECTIVE/OPERATIVE DATE

This bill would become effective January 1, 2007, and would apply to taxable years beginning on or after that date.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

Existing state and federal laws generally allow a depreciation deduction for the obsolescence or wear and tear of property used in the production of income or property used in a trade or business. The amount of this deduction is determined, in part, by the cost (or basis) of the property. In addition, the property must have a limited, useful life of more than one year. The depreciation deduction is generally allowed over a period approximating the property's economic life rather than deducted in the year purchased or acquired. As an incentive for businesses to invest in property, occasionally an accelerated depreciation deduction is allowed. That is, a deduction is allowed at a faster rate than the decline in the property's economic value would warrant.

Board Position:			Department Director	Date
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Depreciable property includes equipment, machinery, vehicles, and buildings, but excludes land. Significant improvements to property are added to the basis of the property and are depreciated over the property's remaining useful life.

THIS BILL

This bill would allow a "small size manufacturer" to depreciate the entire cost of any "qualified manufacturing equipment" over three years using the straight-line method of depreciation beginning in the year the costs are paid or incurred and the following two years.

This bill would define the following terms:

- "Qualified manufacturing equipment" as tangible personal property that meets all of the following requirements:
  - ✓ Expands the manufacturing capacity of the manufacturing facility located in this state.
  - ✓ Creates additional jobs.
  - ✓ Results in the reduction of harmful air emissions and liquid discharges.
  - ✓ An unspecified requirement.

- "Small size manufacturer" is a manufacturer that meets all of the following requirements:
  - ✓ The annual gross receipts from the manufacturing activities are less than $5 million.
  - ✓ The facility is located in a census tract in this state with a poverty level of 61% or higher based on the most recent United States Census.
  - ✓ An unspecified requirement.

IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation concerns. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

While this bill would define "qualified manufacturing equipment," it is unclear if the term would apply to new equipment placed in service or to provide a benefit for equipment already in use or to both.

Because the deduction could apply to new property, the original use of which commences with the taxpayer, a taxpayer could sell an item of qualified property among affiliates and continually apply the special depreciation rules provided under this bill. The author may wish to add a recapture mechanism that requires the taxpayer to use the equipment for a certain length of time in this state. For an item of equipment used less than the specified period, all or some portion of the deduction amount should be added back to the taxpayer's taxable income.

This bill would allow the deduction for the year "costs are paid or incurred." Most depreciation and property credit provisions require an asset to be "placed in service" to trigger eligibility for the tax benefit. Requiring that the equipment be "placed in service" within this state ensures that the asset will be used in California.

This bill would require a qualified taxpayer to expand manufacturing capacity and create additional jobs, but lacks specific standards against which to measure such expansion, such as where the expansion needs to be in direct connection to the equipment, the type of business, or any job created at the facility. The absence of definitions to clarify these terms could lead to disputes between taxpayers and the department and would complicate the administration of this deduction.

While this bill would define “qualified manufacturing equipment,” the definition is contained within a section of the Revenue and Taxation Code (R&TC) administered by Board of Equalization. The author may wish to amend the bill to provide the definitions for the deduction within the section of the R&TC administered by Franchise Tax Board to maintain consistency and avoid confusion for taxpayers and the department.

The author may want to consider providing rules for how leased equipment is intended to be treated for purposes of this special depreciation rule. As drafted, the bill limits the taxpayer that leases the equipment to a manufacturer for use in this state from claiming the accelerated depreciation otherwise allowed by this bill.

This bill would allow a taxpayer to elect the straight-line method of depreciation in place of any other method. The bill is silent about whether the election is irrevocable. As a result, the department would treat the election as though it were revocable. This would allow a taxpayer to change the method of depreciation at any time during the three years. If that is not the author’s intention, the bill should be amended to specify that the election would be irrevocable.

TECHNICAL CONSIDERATIONS

AB 2553 has identical provisions relating to the depreciation deduction; however, AB 2553 allows the costs for “qualified capital expenditures” to be depreciated, instead of “qualified manufacturing equipment,” as identified in this bill. The author may wish to use one term -- either “qualified capital expenditures” or “qualified manufacturing equipment” -- in both bills to maintain consistency.

LEGISLATIVE HISTORY

AB 2553 (Arambula, 2005/06) would allow a credit for amounts paid for qualified capital expenditures and allow a taxpayer to depreciate those qualified capital expenditures over three years. This bill is currently referred to the Assembly Jobs, Economic Development, & the Economy Committee and the Assembly Revenue & Taxation Committee.

FISCAL IMPACT

The department's costs to administer this bill cannot be determined until implementation concerns have been resolved but are anticipated to be minor.

ECONOMIC IMPACT

Revenue Estimate

The revenue impact of this bill is estimated to be as shown in the following table:

Estimated Revenue Impact of AB 2595 As introduced February 24, 2006 Effective for tax years BOA 1/1/2006 Enacted by 6/1/2006 $ Million				
	2006-07	2007-08	2008-09	2009-10
3-year depreciation	a/	a/	a/	a/

a/ Loss of less than $250,000

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Revenue Discussion

It is estimated that the fiscal impact of this bill would be less than $250,000 per year. The bill contains several requirements that would limit taxpayers from qualifying for the deduction. The bill would limit the deduction to businesses with gross receipts of less than $5 million. Businesses that meet this requirement accounted for less than $1 billion in taxes in 2003. In addition, the bill would require the small size manufacturer to be located in a census tract with a poverty level of 61 percent or greater. This requirement further restricts the number of taxpayers that could qualify for the benefit. The 2000 census data indicates that only 25 out of a total of 7,243 census tracts in California had poverty levels higher than 61%. These 25 census tracts accounted for less than 0.2 percent of the state population (approximately 60,000 people out of 34 million). It was assumed that an insignificant number of small manufacturers are conducting business within these tracts because of the extreme poverty level. The accelerated depreciation deduction this bill would provide, while potentially significant for certain assets, would have a relatively small impact overall. It is estimated that the accelerated depreciation deductions would cause, on average, a tax reduction of less than 4 percent for qualified taxpayers in the first year. Due to these restrictions, the bill is estimated to produce a negligible revenue loss of less than $250,000 annually.

LEGAL IMPACT

This bill contains provisions that would target certain manufacturing incentives to California.

The U.S. Court of Appeals for the 6th Circuit ruled in *Cuno v. DaimlerChrysler, Inc.* (2004) 386 F. 3d 738, that Ohio's Investment Tax Credit is unconstitutional because it gives improper preferential treatment to companies to locate or expand in Ohio rather than in other states and, therefore, violates the Commerce Clause of the U.S. Constitution. The U.S. Supreme Court is currently reviewing this case and a decision will be rendered by the end of June, 2006. Although the outcome of this decision and its effects on the income tax credits of other states, including California, is unknown, targeted tax incentives that are conditioned on activities in California may be subject to constitutional challenge.

LEGISLATIVE STAFF CONTACT

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